Climate-Change Rules May Hurt Utilities

Dow Jones (February 26)
Matthew Dalton

NEW YORK--New global warming regulations could pose a major threat to the credit quality of many U.S. electric utilities, according to a new report from credit-rating agency Moody's Investors Service.

At the top of this list are companies with large fleets of coal-burning power plants, such as American Electric Power Co. (AEP), Southern Co. (SO) and Duke Energy (DUK), the report said. With Congress expected to create an emissions trading market for carbon dioxide, the main global warming gas, by the end of the decade, these companies will be forced to buy hundreds of millions of tradable allowances annually to offset the emissions from their coal-burning power plants. "Moody's has not lowered any utility company ratings due solely to the sizable capital expenditures needed to reduce emission levels," the report said. "That could change."

Southern, AEP and Duke all operate in states with regulated electricity markets. State regulators usually allow their power companies to pass through environmental compliance costs to their customers. And utilities are often allowed to earn a rate of return on environmental upgrades to their plants.

But this process may not go smoothly when it comes to carbon dioxide costs, according to the Moody's report. Regulators have allowed companies to raise rates to pay for tens of billions of dollars in spending on new electrical infrastructure over the last few years. As the rate increases pile up, regulatory commissions may increasingly oppose the healthy returns on investment sought by utilities.

"While Moody's believes that most commissions are likely to grant timely recovery of prudently incurred mandated environmental costs, the resulting increase in electricity prices may make recovery of other operating costs and capital investments more challenging," according to the report. "Such a scenario could cause negative rating actions within the sector."

Southern, the Atlanta-based utility giant, emits 172 million tons of carbon dioxide from its plants in the U.S. each year, making it the country's biggest carbon dioxide emitter and the sixth biggest in the global power sector, according to a database run by the Center for Global Development, a Washington-based think tank. American Electric Power is the second biggest U.S. emitter, with annual emissions of 169 million tons.

Duke, based in Charlotte, N.C., is the third largest U.S. carbon dioxide producer, with annual emissions of 108 million tons. Arlington, Va,.-based AES Corp. (AES) also emits 108 million tons annually, but much of these emissions occur at plants owned outside the U.S.

Xcel Energy Inc. (XEL), Progress Energy (PGN), Dominion Resources (D) and Ameren Corp. (AEE) each emits more than60 millions tons of carbon dioxide annually, according to the database.

The impact of climate change laws to the power sector will largely be determined by how many allowances they'll be forced to buy, an issue that is a topic of fierce debate in Congress. The federal government can either give some of these allowances to the industry for free or require all of them to purchased, at large cost to the industry.

Equity investors are also worried about backlash from regulators, particularly as the economy slows and ratepayers become pressed to shoulder rising electricity bills. At $10 a ton - significantly less than the price of carbon dioxide allowances in Europe - the cost of purchasing allowances would be over $1 billion annually for Southern, AEP and Duke at their current emissions levels. That's a major burden, one that investors fear might have to be shared by companies and their customers. Companies in certain deregulated electricity markets could face even bigger challenges than their brethren in regulated markets. These companies, such as Energy Future Holdings - formerly TXU Corp. - NRG Energy Inc. (NRG), Mirant Corp. (MIR) and Reliant Energy Inc. (RRI), usually can't pass through all their compliance costs to electricity consumers. That means they have to spend their free cash buying allowances. Each of those companies emits more than 48 million tons of carbon dioxide annually, according to the Center for Global Development, with NRG emitting the most, 70.9 million tons annually. Some of this emissions allowance cost will be recovered through higher electricity prices - but some will be paid for investors.

Energy Future Holdings, now owned by the private equity firms Kohlberg Kravis Roberts & Co. and TPG, may face the most acute difficulties dealing with new global warming regulations. As part of their buyout, KKR and TPG loaded $40 billion of debt onto the company. Its annual interest expense "and related charges" is now $3.6 billion, according to a regulatory filing in October.

In the Texas market, where Energy Future Holdings generates power, natural gas-burning power plants usually determine the price of electricity received for all generators. But these plants produce less carbon dioxide than the coal-burning plants owned by Energy Future Holdings. That means electricity prices won't rise enough to cover the cost of buying allowances for its coal-burning plants - and Energy Future Holdings will have less cash to serve that big pile of debt.